# Energy Market Reform

Our energy market is a failure. It fails to deliver on affordability, on fairness and on stability. It's part Casino Capitalism, part State controlled, has significant dysfunctions at it's heart, far more complexity than required and fundamentally does not work for Britain. It needs reform. There are three main steps available to our new government for the fastest and most impactful change.

## 1 Take control of wholesale energy prices.

We have price control of retail energy bills in Britain. But not wholesale. For that reason we can't actually control our energy bills.

The Conservatives imposed the current price control regime on retail energy suppliers, nearly seven years ago - to protect households from un necessarily high energy bills, from profiteering. They did nothing to protect businesses. As well as nothing to control wholesale energy prices - the largest element in the make up of retail energy bills.

The fact that we already have retail price control is important in the context of introducing wholesale price control now. Most people's first response to the idea (of price control) is along the lines, surely that can't be done, interfering in markets and private business and so on - it sounds like a big or difficult thing to do. Something against the long established orthodoxy.

But it's already been done - in the retail energy market. And by 'the party of business'. Making it harder if not impossible to argue this is some kind of leftie, anti market move.

We can present it as finishing the job the Tories started, to enable us to actually control energy prices to bring them down and keep them there - and not just for homes but for businesses too. A move in the national interest.

Energy prices are currently out of control, every global crisis sends them soaring with impacts that undermine our entire economy. Wholesale price control is a big step towards independence from this volatility.

Another important point is that the Tories simply imposed price control on retail energy suppliers. Energy retailers were and are mostly foreign owned companies, a mixture of private, listed and state owned. This new price control was a major market intervention and change to the rules of doing business in Britain. The response of the retail energy companies was to just get on with it.

It's hard to understand why the Tories thought that retail price control would bring energy bills under our control. Leaving wholesale prices to be driven by global markets and unrestricted profit making, when wholesale prices are the biggest element in the make up of retail prices makes no sense. Wholesale prices are inherently volatile, in this current system, since they are largely set by global markets - even when we make energy here. It ought to be obvious that we can't control retail prices unless we also control wholesale prices. That is probably true in any market.

As a result of controlling only retail prices we have higher bills than we need and a near continuous media focus on energy bills, because we need a quarterly change in the price cap, to keep up with wholesale movements, creating headlines - even when bills go up by less than £1 per week.

But of course they do go up by considerably more - they quadrupled in the first energy crisis this decade - due entirely to the global price of oil and gas and the degree to which we allow that to set the price we pay for energy, even when we make it here, such as from the wind and sun. It's vital that we reform our energy market to prevent this ever happening again.

The retail price cap was, at best, half the job. The biggest consequence of it's inadequacy came in 2022 when we experienced the first energy crisis under the new price cap regime and half the market players went bankrupt, over 30 of them. The reason for this was as brutally simple as it was foreseeable - wholesale prices were not controlled and they rose due to the crisis, to become higher than retail prices - which were held in place by the OFGEM managed price cap. Energy cost more to buy than it was allowed to be sold for, the consequences were obvious.

This could happen again despite the move to a quarterly review (as opposed annual) - three months is a long time in global energy markets.

That's the background, the Tories did half the job and in doing so bankrupted half the market participants and created a near constant media focus on energy prices.

Labour under Andy Burnham has the chance to finish what the Tories started, to correct their mistake - and introduce wholesale energy price control.

## How do we do it?

It's a straightforward and well trodden path to implement. We can use the Contracts For Difference (CFD) mechanism which has been so successful in supporting new green energy projects - the CFD removes market price risk, which in turn reduces required profit margins to an economic minimum - and the cost of energy reduces with it.

A significant proportion of Britain's generation fleet already operates under a CFD. Almost half.

New green energy projects of course but also new nuclear and legacy biomass (Drax) all have a CFD in place - they are all price controlled in this way.

The exceptions to this are legacy green, legacy nuclear - and legacy gas.

Thus we simply need to extend the scheme that is already in place for nearly half the market - to the rest of it. Creating a consistent approach and bringing wholesale prices completely under price control.

Legacy green and legacy nuclear have had public financial support via forerunner schemes to the CFD which have now ended. They have paid back their capital costs and are now operating in the market at the cost of fuel and operations - reaping windfall profits from globally driven energy prices. There's a good moral argument to stop this. And say it's time to make them work for the public, it's payback time for the public funding that got them built in the first place..

Legacy gas generators have had public funding through capacity payments, payments for simple being available to work - not actually generating. The value of that is over £12 Billion in the last decade. The argument here then is the same, public funding helped establish them, time for the public to be repaid.

In any event, public funding or not, the moral case to control the price generators charge us for electricity made here is strong, the case to prevent windfall profits which come about though 'rip off' energy bills - is strong.

Just as we expect 'a fair days pay for a fair days work' - we should introduce a new expectation into our economy of 'a fair days profit for a fair days business' - and not allow Casino Capitalism to operate to our great detriment.

Price controlling gas would also reduce our energy bills at times when gas is called upon to balance the system - when we see extraordinarily high prices demanded and paid - up to 100 times the normal price, for short term grid support.

In all generation cases the cost of fuel and operations are well known, published information. Thus setting a price is straightforward, on a costs plus profit margin basis.

It will be simpler than setting the retail price, which has many more elements.

CFDs for legacy generation could be updated periodically, to allow for movements in costs over time, perhaps reviewed annually and adjusted where cost levels rise or fall - by a given percentage.

Legacy gas (CFDs) will need more frequent updating as the cost of fuel is set by global markets and is inherently more volatile.

But this happens in retail price setting already as the global price of gas sets more or less the price of all electricity in Britain. It does this in two ways, one directly through gas generation's market share (around 30%) and secondly through 'the link' - more on that below.

OFGEM uses a complex formula which takes into account the backward and forward looking price of gas - as a key element in arriving at the average price of retail energy in any given period. With legacy gas CFDs it will be easily possible to identify the cost of gas to any given generator over any given time period - their commitments to buy and their actual purchases will be clear.

As things stand, in the current patched together system we have - which is neither one thing nor the other, neither a free market nor a state controlled one - we have a windfall tax which sets out to take back unearned windfall profits from the non price controlled generators. It's an imperfect approach, necessarily complex to detail and enforce - and at best is simply bolting the stable door after the event. It is also unpopular and divisive. We can scrap this tax if we put wholesale energy under price control - if we complete the control we already have.

Finish what the Tories started. And take actual control of the cost of energy, via wholesale price control. That's how it boils down.

## 2 Extend price control to our North Sea.

Putting an arm around our North Sea oil and gas industry.

We should extend the logic of wholesale energy price control to include our own north sea oil and gas - that will complete the transformation of our wholesale energy market and augment the benefits significantly.

Giving fossil fuels the same support mechanism as green energy already has is a politically strong message. Who could argue with that.

Our modelling shows significant annual savings if we allow a 10% profit margin (generous by retail energy standards) on top of published operating costs. Just as importantly such a policy has the benefit of protecting jobs and investment in the sector, from global volatility. Our North Sea production is increasingly exposed to global price volatility as fields become less economic through declining output. They become more vulnerable to cliff edge moments where sudden price drops causes closure on economic grounds - perhaps prematurely in the context of extractable resource and definitely in the context of a managed transition.

Price control of oil and gas - our own oil and gas, will also protect the country from windfall profits, the flip side of which is sky high energy bills - and do away with the need for a windfall tax in the north sea also. The whole industry can get on with the job of extracting what remains - protected from global volatility. And we can have a proper transition that works for everyone. Our North Sea is all but empty of course, the next ten years will see significant changes, reductions, in output and significant risk for declining fields.

Price control - of our North Sea oil and gas could provide the answer to the current predicament of allowing new drilling - the argument for which centres around bringing down bills. The claim that new production can bring down bills is manifestly false, when global markets set the price, whether we produce it, or buy it from elsewhere. No amount of new drilling can bring our energy costs down as things stand.

However, with price control in place the economic argument actually makes sense. We can save money through new production. The secondary argument for more drilling - that we should produce the oil and gas we need (as far as we can) rather than buy in foreign supplies - rises to prominence with price control in place and the balance shifts. Price control of North Sea oil and gas - or putting an arm around the north sea, can make sense of the current situation, the pressure Labour are under to allow new production but stay committed to net zero and tackle the cost of living crisis. It would be a pragmatic approach through the middle. Offering something to all sides. We may be able to shut this contentious issue down and move on, if we use price control to obtain actual lower energy bills from a limited amount of new production that already has a licence.

Price control of our North Sea oil and gas could also help us with the relatively imminent and significant cost of decommissioning north sea infrastructure (estimated at around £50 Billion) - a burden that will fall on the public and for which no government has yet made provision for. Over the next ten years we can place some of the savings from a price cap into a decommissioning fund - and take responsibility for this long avoided problem.

Worth noting that production of gas in our North Sea started in 1966, oil in 1975. Global commodity markets for oil began nearly ten years later in 1983 while for gas it was much later still, 2003 in Britain. Before that private companies and OPEC set the price of oil and gas in different parts of the world.

We can see that global market pricing of oil and gas does not work for our country, for our people. It's not some kind of carved in stone necessity, not a law of physics, not even an always present system - it's a relatively recent economic construct and we can construct another.

## 3 Breaking the link.

A price controlled wholesale energy market will make a significant difference to our energy bills, making them lower and more stable - for homes and, for the first time - for businesses. But breaking the link is still the biggest issue.

We need to reform the dysfunctional daily auction that pays all generators the same price as the most expensive one - typically gas.

The CFD (used as a wholesale price control mechanism) will recycle windfall profits back to bill payers, with a time lag - turning an affordability problem into a cash flow one - better but not perfect.

North Sea price control will bring down the cost of around 30% of the gas we use - reducing our fossil fuel bill.

But if we allow the link to continue the global gas price will still have a significant affect our our wholesale energy prices because most of the gas we need will still come from abroad and some of that will be used in power generation. Unless we break the link, that gas generation will force us to pay more for our price controlled wholesale energy than we need to.

And even though that will be recycled back to energy consumers over time, we will still suffer from energy bills higher than they need to be and the knock on economic impacts such as higher inflation and lending rates. It is not enough to control our own generation - we need to break the link that inflates the cost of all forms of generation to the same highest price - in order to minimise the harm that volatile global market prices for gas does to our economy.

Breaking the link is straightforward enough - we just need to change the daily auction from 'pay as clear' (pay all the highest bid price) to 'pay as bid'

Our macro economic modelling of the impact of the link shows the extent to which this link undermines our entire economy. In 2023 we paid £43 Billion more for our energy than we would have if the link had been broken (£13Bn more for home energy and £30Bn more for businesses). This added 1.5 percentage points to inflation and nearly 1% to BoE lending rates. We suffered a big dent in our GDP - of around 1.5%.

All this for a link that has no obvious purpose, a link which nobody has ever defended in terms of what we need it for, what it might be vital to - because there is no argument that can be made.

## Summary

There are three main reforms we need to make which together will transform our energy market - and make it work for Britain.

The first is to introduce wholesale price control - finishing what the Tories started with their retail price control, half the job and never capable of doing what they intended.

The second is to extend price control to our North Sea sector. Giving the same protection that we give to green energy - to our North Sea industry. Protecting jobs and investments and maximising resource extraction of the fields we have, ensuring a proper transition - and making some sense of the arguments for new production.

The third is to break the link. The arbitrary market mechanism that enriches generators at the expense of bill payers while undermining our whole economy.

In combination these measures will transform our energy market, our energy bills - and their impact on the whole country - our people, businesses and entire economy.

## The Energy Market Reform Bill?

The Tory Energy Prices Act (2022) was passed in 13 days - it gave emergency powers to break the link and impose a price cap (using a CFD) on legacy green generation.

In 2018 the Tories passed legislation to enable retail energy price control, this took five months to pass.

Both of these are useful examples when considering how quickly we can make these reforms - and actually in terms of political precedent.

Labour should pass their own bill - to cover the broader steps that will complete the job, actually do the job. Complete the price control of wholesale energy including oil and gas - and break the link.

We can transform Britain's energy market this way and with it our economy, strike the biggest blow possible against the cost of living crisis that affects so many - achieve not just lower prices but stable ones too, make sense of North Sea drilling, provide for the decommissioning cost black hole and scrap windfall taxes.

We can apply principles consistently across the entire market, fixed price and fixed profit margins in energy wholesale and retail - and in oil and gas. We can provide the price certainty which reduces required profit margins to an economic minimum and with it - energy prices.

The lowest energy prices we can have are available to us this way. We can make our energy one thing - not part one thing, part another. We can have a state controlled energy market in which private businesses thrive.

We can make our energy market work for Britain. For the first time since privatisation.

## How quickly can we implement these reforms?

I believe six months is a good target.

Six months in which we start consultations with the industries affected, start the detailing of the changes to be made and start the legislative process, in the expectation that the legislation can be passed readily in that timeframe - probably sooner.

The Tories passed their Energy Prices Act in 13 days (on an emergency basis) and their retail price control legislation in five months.

It's ambitious and bold - exactly what we need to tackle these systemic market failures and to do so on a timetable that people will appreciate. Business will adapt, and get on with the job, we've seen that already with retail price control.

An 'Energy Market Reform Bill' will give the legal powers for these changes, the moral case is clear and the technical path is straightforward.